Lucas Papademos: Remarks on the ECB's December 2005 Financial Stability Review

Opening remarks by Mr Lucas Papademos, Vice-President of the European Central Bank, at the press briefing on the occasion of the publication of the December 2005 Financial Stability Review, Frankfurt, 8 December 2005.

The slides can be found on the website of the European Central Bank www.ecb.int.

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Ladies and Gentlemen,

I. Introduction

Welcome to this press briefing on the occasion of the presentation of the December 2005 edition of the ECB's Financial Stability Review, which is published semi-annually, in June and in December each year.

My presentation today will have three parts (see slide 2): I will start with some introductory remarks, outlining the purpose, the scope, the method of analysis and the structure of the Review. Thereafter, I will highlight the main sources of risk and vulnerability which we have assessed as emanating from four areas: *(i)* the global macro-financial environment; *(ii)* financial markets; *(iii)* the balance sheets of euro area households and corporations; and *(iv)* financial institutions, including banks and insurance companies. Finally, I will provide an overall assessment of the outlook for financial stability in the euro area.

By publishing a Financial Stability Review, the ECB pursues three objectives: first, promoting awareness of issues relevant to safeguarding the stability of the euro area financial system and encouraging an informed debate on these; second, providing an overview of sources of risk and vulnerabilities with regard to financial stability; in this way, the review seeks to play a role in preventing crises; and, third, analysing ways of promoting and maintaining a stable financial system.

The scope of the Review is wide, covering the euro area financial system, notably banks, other financial institutions (e.g. insurance companies), capital and money markets and financial infrastructure (payment and settlement systems). As such, it is the only Report of this kind for the euro area.

The analysis underpinning the assessment of the financial stability outlook comprises three elements:

- an evaluation of the robustness of the financial system;
- an identification of plausible and systemically important risks to euro area financial stability;
- an assessment of the ability of the financial system to cope with shocks in the event that some combination of the identified risks and vulnerabilities were to materialise.

It should be stressed that calling attention to such sources of risk and vulnerability does not mean seeking to identify the most probable outcome. Rather, it entails highlighting potential and plausible downside risks, even if these are unlikely to materialise.

The Review has been prepared with the close involvement of the Banking Supervision Committee of the European System of Central Banks, which is a forum of cooperation among the national central banks and supervisory authorities of the 25 European Union Member States and the ECB. The combination of the micro perspectives of supervisors with the macro perspectives of central bankers contributes to making this assessment as wide-ranging as possible. The Review also serves as the basis of semi-annual financial stability discussions at the ECB Governing Council and therefore represents the common view of the Governing Council.

The Review is organised in four main chapters: first, an overview, setting the scene with a self-contained analysis and assessment; second, an analysis of the macro-financial environment which assesses the financial balances of non-financial sectors of the economy; third, an inspection of the financial system which forms the core of the Review; and, fourth, a section with six special features, i.e. short articles aimed at providing analytical and contextual underpinnings. The first article deals with measurement challenges related to financial stability analysis. The second analyses financial market contagion. The third assesses the financial vulnerability of mortgage-indebted euro area households. The fourth study looks at determinants of euro area banks' profitability. The fifth article looks at the effects of the new accounting framework on banks. The final study looks at the financial stability issues related to central counterparty clearing houses. In addition to the special features, the Review contains 20 boxes as well as a statistical annex.

II. Main areas of vulnerability of the euro area financial system

Let me now turn to the substance of the Review and present the main findings of the analysis and assessment. I start by looking at the main developments in the global macro-financial environment (see slide 4).

II.1. Global macro finance

Global imbalances continued to widen in 2005. The chart on the left of slide 4 shows that among the main economic areas, the United States remains the largest borrower country. However, there have been changes in the composition of the global creditor countries, with the shares of Japan and the euro area diminishing, while China and, in particular, the oil producing countries, have grown in importance in financing the US deficit in 2005.

The chart on the right of slide 4 focuses on the evolution of the US deficit. The total net lending of the US economy reached new post-Bretton-Woods records of 6.5% of GDP in the first quarter of 2005, and narrowed slightly to 6.3% of GDP in the second quarter. For much of the time since 2000, the main domestic sources of the US current account deficit have been growing fiscal imbalances and heavy household sector borrowing. On the other hand, rather atypically, the corporate sector enjoyed a financial surplus. This may not last, however, as the corporate sector begins to leverage again.

Overall, while the sustainability of current account positions seems rather unproblematic in the short term, the expansion of imbalances exposes the global financial system to the risk of sharp correction in the medium term, in particular if confidence were to suddenly deteriorate in financial markets.

An additional significant risk to euro area financial stability during the current year has been the surge in oil prices. Slide 5 highlights some of the implications for the global financial system of the rise in oil prices to levels that, in real terms, have remained close to the peaks reached in the late 1970s. While the impact of elevated oil prices on the financial system has thus far been less substantial than previously feared, risk premia in some segments of the global equity markets could nevertheless have been adversely affected. The chart on the left plots the real oil price against the US equity market earnings yield premium. The relatively close co-movement between these two variables seems to have carried over to the more recent episode of increasing oil prices, possibly explaining part of the relatively subdued developments in US equity markets in the current year.

Regarding the corporate credit markets, in 2005 problems in the US automobile and airline sectors – both of which are sensitive to the level of oil prices – have created periods of short-lived turbulence in credit markets, including the markets for more complex structured credit instruments. Looking ahead, a key question in credit markets is the likely timing of the turn of the current very benign credit cycle. The chart on the right in slide 5 shows that the decline in global corporate default rates stabilised at a low level in the first three quarters of 2005 after a very marked decline in 2002-2004. Partially reflecting the effect of high oil prices, Moody's rating agency currently forecasts that global default rates will pick up somewhat in early 2006, heralding less favourable credit conditions to come. It should, however, be noted that similar forecasts made at the beginning of 2005 proved to be inaccurate.

II.2 Financial markets

In the global fixed income markets (see slide 6), the flattening of yield curves throughout the second and the third quarters of 2005 has been something of a puzzle. More recently, worries about global inflation, mainly driven by high oil prices, seem to have reversed the decline in long-term bond yields, at least temporarily. The low level of US ten-year bond yields in particular remains a conundrum that is difficult to reconcile with underlying macroeconomic fundamentals. At the same time, and as a corollary, concerns about the risk of an unexpected and abrupt upturn in these yields have remained. The chart on the top left of slide 6 illustrates the puzzle by plotting the evolution of the US 10-year bond yield against the consensus expectations on US nominal GDP growth ten years ahead, a proxy for the level of bond yields consistent with expected future fundamentals. In “normal” circumstances, the two would be expected to remain rather close to each other. The chart shows, however, that for the US, since early 2002 the bond yield has been persistently lower than the expected future growth rate of nominal GDP. In the euro area, as shown in the chart on the bottom left on slide 6, although the 10-year bond yield has also declined below the 10-year nominal GDP growth expectations, the margin is substantially narrower.

The low levels of bond yields can be partly explained by increasing demand by institutional investors, such as insurance companies and pension funds, for long-term bonds. Ageing populations and increasing private provisioning of pensions in many euro area countries, as well as accounting changes and balance sheet repair, have forced financial institutions to resort to longer-term bonds in order to correct maturity mismatches in their balance sheets. The chart on the right of slide 6 illustrates how net purchases of long-term bonds relative to quoted shares has sharply diverged since 2002. Insofar as the declining bond yields reflect such structural factors, the potential for a reversal of the trend, should it happen, could take place more gradually than previously feared. However, it should be noted that other factors have also affected the patterns of global portfolio behaviour, which led to an unusual increase in the net demand for long-term bonds and drove down risk premia and therefore bond yields.

II.3. The balance sheets of euro area corporations and households

Let me now briefly discuss developments in the euro area economic environment (see slide 7), focusing on developments in the corporate and household sectors that are particularly relevant from the point of view of the outlook for financial intermediaries’ credit portfolios.

Starting with the corporate sector, there are signs that earlier weaknesses in demand for external funding by the non-financial corporate sector is coming to an end. This is reflected by the increase in lending. At the same time, reflecting the better financial condition of firms, credit standards by banks to firms have been relaxed somewhat, as shown in the chart on the left on slide 7 (where the vertical axis measures changes). Encouragingly, these developments also extended to small and medium-sized enterprises, which in many euro area countries had faced difficult circumstances over the past few years. Overall, euro area corporate sector balance sheets show signs of improvement, after several years of de-leveraging and extensive cost-controlling.

Turning to the household sector, the most important development continued to be further rises in house prices in many euro area countries and in the euro area as a whole, as shown in the chart on the right on slide 7. However, prices continued to fall in some countries, while in others, where house prices increased rapidly in the past, prices have shown signs of moderation. Given the relative robustness of household sector balance sheets in the euro area and the still, on average, conservative loan-to-value ratios applied to mortgage lending, more substantial credit risks to financial institutions would materialize only in the currently rather unlikely event of a simultaneous increase in unemployment and a fall in house prices. Nevertheless, against the backdrop of signs of further relaxation of credit standards and the possibility of a substantial negative impact of a potential fall in house prices in some euro area countries on their financial systems, the housing market warrants further close monitoring.

II. 4. Financial institutions

Consolidated data on the euro area banking sector’s financial results are available for the full year of 2004. The figures, further supported by non-consolidated data for the first half of 2005, paint a picture of strong profit growth and comfortable solvency ratios (see slide 8).

In 2004, the average return on equity (ROE) for euro area domestic banks, the main indicator signalling increased profitability, increased by almost three percentage points from 2003, reaching 10.5%. The chart on the left on slide 8 illustrates that in addition to the increase in average profitability, the distribution of ROE for euro area banks shifted in the direction of higher profits. The chart shows the proportion of euro area banks’ return on equity – weighted by each country’s total banking assets – in 5% intervals. For example, banks with a ROE falling within the 5-10% interval represented approximately 28% of total euro area banking assets in 2004. The shift in the distribution of ROE shows that both the best and worst performing banks had become more profitable in 2004 compared to 2003.

Against the background of a rather benign credit environment in the euro area, the aggregate flow of provisions as a share of total assets declined further between 2003 and 2004. The stock of provisions in euro terms also fell in 2004 from the previous year. Beyond the short-term horizon, the overall low levels of provisioning flows could be questioned as a less benign credit environment could make the situation more difficult for banks. Possible triggers for a deterioration include an unanticipated sharp rise in short and long-term interest rates, or an unexpected worsening in the macroeconomic environment. In contrast to the observed changes in provisioning flows as a share of total assets, however, the ratio of provisioning stocks to non-performing loans increased as shown by the chart on the right on slide 8. This mainly reflects an improvement in banks' asset quality in the euro area as a whole. It should be kept in mind, however, that the quality of banks' assets is sensitive to changes in the phase of the credit cycle.

Looking ahead, the low level of provisioning flows could become a problem if the current rather benign credit conditions were to deteriorate and the number of non-performing loans to increase. Given that lending to the household sector, has, for several years, been the most rapidly growing line of business for banks, the continuing growth of exposures to the household sector is a potential source of increasing credit risk. However, the quality of credit granted to households tends to be generally higher than that extended to the corporate sector.

In 2004, the last full year for which figures are available, profitability in the euro area insurance industry improved further, with the exception of the re-insurance sector (see slide 9). The strengthening of financial positions was mainly driven by strong underwriting results. Capital bases improved in both the non-life and reinsurance industries in 2004, whereas solvency ratios in the life insurance industry remained broadly unchanged. The chart on the left on slide 9 shows that there continue to be divergent developments among the various sectors of the industry. In the life insurance sector, the average ROE increased between 2003 and 2004. Non-life insurers enjoyed an even more significant improvement in profitability. By contrast, the reinsurance industry saw a marked decline in profits in 2004. Profits in the non-life sector were driven by strong underwriting performances. In the life insurance sector, lower guaranteed rates of return and cost-cutting supported the results. Re-insurers suffered mainly from falling net investment income and a reduction in risk transfer from the non-life sector to the re-insurance sector.

The solvency positions of insurers may be broadly measured by the ratio of surplus to net premiums written. As shown in the right-hand chart on slide 9, in the non-life and re-insurance industries, this ratio rose in 2004 from the previous year. Despite rather subdued profits, the capital base of the reinsurance industry grew as companies limited the amount of dividends distributed to their shareholders. In the life insurance industry, there was a slight decline in the solvency ratio in 2004.

Regarding unregulated financial institutions, the risks associated with hedge funds have remained a topical issue in 2005 (see slide 10). The ECB, in collaboration with the BSC (national central banks and supervisors), carried out a survey of EU banks' exposures to hedge funds, which has been published and is now available on the ECB's website. The December 2005 Financial Stability Review contains a box summarising the key findings of the survey.

The chart on the left on slide 10 shows that according to publicly available data, inflows to the hedge funds sector continued in the first half of 2005, albeit at a decelerating pace. The chart on the right on slide 10 illustrates that at least certain hedge fund strategies suffered losses in March-April 2005 owing to the turbulence in the corporate credit markets that was generated by the widely expected downgrades of two large US automakers which subsequently materialised in May. This weaker performance in hedge fund returns may, at least in part, explain why inflows tapered off somewhat.

III. Overall assessment

Having reviewed developments in the key parts of the financial system, the overall assessment of risks to euro area financial stability can be formulated as follows (see slide 11).

A number of recent positive developments support the judgement that the euro area financial markets, institutions and infrastructures are robust and capable of withstanding shocks: First, the pace of global economic activity has remained rather strong. Second, balance sheets of large corporations have improved further, with signs of recovery also extending to the small and medium-sized enterprise sector. Third, the balance sheets of euro area banks and insurance companies have also continued to strengthen.

At the same time, these positive developments are clouded by the fact that risks and vulnerabilities are also growing (see slide 12). Global imbalances have continued to widen. In addition, it cannot be excluded that the global hunt for yield could have extended to riskier segments of financial markets, further accentuating the risk of disorderly market corrections as global liquidity is gradually reduced. High oil prices and rising house prices add to the sectoral risks, creating vulnerabilities to financial institutions' future performance. Finally, if the credit environment turns worse than currently anticipated, the present level of loan-loss provisioning by euro area banks may prove to be insufficient.

Overall, with shock-absorption capacities improving, but risks and vulnerabilities rising, the financial stability outlook continues to rest upon a delicate balance. While the probable outcomes could, at this stage, best be described as bi-modal, a positive outcome remains the most likely prospect in the period ahead.

Thank you very much for your attention.